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IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA, *Appellant*,

v.

FRANCHISE TAX BOARD, *Appellee*.

On Appeal From The Court Of Appeal Of California, First Appellate District

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

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BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as *amicus curiae* in support of the Appellant in the above-captioned case. Written consents of Appellant and Appellee have been obtained and are attached herewith.

OPINIONS BELOW

The Opinion of the Court of Appeal of California, First Appellate District, is reported at 117 Cal. App. 3rd 988, 173 Cal. Rptr. 121 (1981); the memorandum opinion and judgment of the California Superior Court are not reported.

INTEREST OF AMICUS CURIAE

The Council of State Chambers of Commerce (COUNCIL), organized in 1932, consists of 34 Chambers of Commerce. The Committee on State Taxation (COST), one of the three advisory committees of the COUNCIL, consists of 187 corporate members which conduct a substantial portion of the interstate and foreign commerce of United States taxpayers. One of COST's principal activities has been to work with the states and others toward developing fair and equitable standards in the income allocation and apportionment aspects of state taxation.

Member companies of COST are representative of that part of the Nation's business sector which is most directly affected by state taxation of interstate and foreign commerce operations. COST is, therefore, vitally interested in cases such as this one which present issues significantly affecting state and local taxation of interstate and foreign commerce.

This case involves the application by California of the "worldwide combination" formula to generate substantial additional revenues based upon the "combined" incomes of Appellant and its subsidiaries and affiliates. Unlike a similar case currently before this Court, *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, No. 81-349, (argued before this Court on April 19, 1982 and restored to the calendar on May 3, 1982 for rehearing during the next term), this case has a record establishing the absence of an underlying "unitary" relationship, and the existence of gross distortion. Unlike Caterpillar Tractor Company, the taxpayer herein is vigorously opposed to the "worldwide combination" formula.

From the constitutional viewpoint, COST is particularly interested in this case because the Appellant, Container Corporation of America, has presented the Court the following substantial question:

Whether California's application of its "worldwide combination" formula to a domestic corporation and its foreign subsidiaries, whereby the operations of all the members of the affiliated group are treated as a single profit-generating enterprise whose profit is assigned to California on the basis of the relative amounts of property, payroll and sales receipts of the affiliated group in California to property, payroll and sales receipts of the group worldwide, is repugnant to the due process and foreign commerce clauses of the federal constitution and in conflict with well-established federal tax policy when:

1. The foreign subsidiaries are not functionally integrated with the California taxpayer and there is no substantial flow of goods among them or between them and the domestic parent;

2. The formula used to assign income of the affiliated group to California results in a significantly greater amount of taxable income for California tax purposes than would otherwise be the case because of differences in the cost of capital goods, labor productivity, market forces and managerial efficiency in California and the foreign countries in which the foreign subsidiaries operate; and

3. The "worldwide combined" method followed by California taxes income also taxed by the foreign subsidiaries' domiciliary countries.

The Court has approved state taxation of a "classic" vertically-integrated, single company "unitary business" operating within a state and abroad if a fair apportionment is made. *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271, 282 (1924). In *Mobil Oil Corporation* v. *Commissioner of Taxes*, 445 U.S. 425, 439-440 (1980), the Court upheld Vermont's taxation of dividends received by a New York corporation from its non-United States subsidiaries after Mobil (1) failed to demonstrate that its dividend-paying subsidiaries were engaged in business activities unrelated to its "integrated petroleum business" and (2) did not dispute "the accuracy or fairness of Vermont's apportionment formula."

445 U.S. at 434. More recently, in *ASARCO, Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (June 29, 1982), and *F. W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, 50 U.S.L.W. 4957 (June 29, 1982), the Court rejected the states' taxation of dividends received by nondomiciliary parent corporations from their non-United States wholly or partly-owned subsidiaries after finding that, unlike Mobil, the taxpayers had succeeded in proving that the dividend-paying subsidiaries were "discrete business enterprises" and not part of "unitary businesses" conducted in the taxing states with the parent corporations.

The Court has never decided whether a state may, by means of a "worldwide combination" formula, tax the non-United States income of a taxpayer's subsidiaries operating in foreign countries, when the subsidiaries and the taxpayer are not functionally integrated and that income has already been taxed by foreign jurisdictions.

The decision of the Court of Appeal of California, sanctioning formula apportionment of the "worldwide combined" income of affiliated corporations for state income tax purposes, is repugnant to longstanding judicial interpretations by this Court of the due process and commerce clauses of the federal constitution. If it is not reversed, it will lead to international multiple taxation of multinational corporations and impair federal uniformity in an area where federal uniformity is essential.

SUMMARY OF ARGUMENT

A state's inclusion of income of subsidiaries operating outside the United States in the apportionable base under the circumstances of this case offends the Due Process Clause of the Fourteenth Amendment. It also violates the Commerce Clause because it (1) constitutes an unreasonable burden on foreign commerce and (2) is contrary to, and interferes with, the established tax policy of the United States.

Fundamental to a state's attempt to "combine" extraterritorial income is the "unitary business" relationship which must exist between the affiliated members of the combined group. This prerequisite is not met where the operations of foreign subsidiaries are not part of a functionally integrated business with the domestic parent corporation and no significant property is transferred between the parent and its foreign subsidiaries. It is not met in the case at hand.

The basic assumptions underlying the equitableness of the unitary system of taxation applied by California ("worldwide combination") are that the operations of individual units of a commonly-controlled group of corporations are so interrelated as to earn a profit only from transactions with others outside the group, and that property, labor and market forces will produce approximately the same rate of profit wherever the units are doing business. These assumptions can be shattered when such an apportionment formula is applied beyond the borders of the United States to "combined" companies operating in foreign countries. An arbitrary and distorted result is then produced as a result of the broad economic, political and social differences which exist between this country and most of the remainder of the world.

If the unitary system is to be applied to affiliated groups which include corporations doing business in foreign countries, it should be limited to those situations in which there is functional integration as demonstrated by a substantial flow of goods. In the context of "worldwide combined" reporting, this should be the definition of a "unitary business".

Alternatively, if "worldwide combined" reporting is sanctioned in situations where "unitary business" relationships exist, it should only be allowed when factor adjustments are made to bring into accord factors which are not comparable.

ARGUMENT

Due Process

Container's Foreign Subsidiaries Are "Discrete Business Enterprises" And Taxation Of Their Income By California Contravenes Due Process

This Court is being asked by the California Franchise Tax Board to sanction a system of reporting for state income tax purposes that considers the separate operations of affiliated corporations as though they are inseparable parts of a single profit-generating process. Accordingly, intercorporate transactions between members of the affiliated group are disregarded and income is recognized only with respect to transactions outside the group. This income is then apportioned to state taxing jurisdictions by the combined factors of the group. This apportionment procedure assigns a portion of the profit generated by the group to each taxing jurisdiction relative to the property, payroll and sales receipts of the group in that jurisdiction. No attempt is made to determine and tax the profit produced by the individual members in the taxing jurisdictions in which they operate.

The importance of restricting the definition of a "unitary business" in relation to taxpayers with subsidiaries doing business in foreign countries (or taxpayers having parent corporations in foreign countries) is attributable to the incompatibility of the separate entity arm's length method used by the principal trading partners of the United States and the unitary system of California. The unitary system imposed by California depends on the mechanism of an apportionment formula composed of property, payroll and sales receipts factors. The apportionment formula is relative. That is, the amount of income assigned to a particular taxing jurisdiction is a function of the relationship of the factors of the formula located in the taxing jurisdiction to the factors located elsewhere. For example, if a taxpayer earns a return of 10% on its property and labor located in State A and 15% on a like amount of property and labor in State B, for a total

profit of $10,000, the apportionment method will assign $5,000 to State A and $5,000 to State B based on the relation of the factors. This apportionment disregards the difference in profit rates from operations in the two states. On the other hand, under the arm's length method, if the operations in State A are conducted by Subsidiary A and those in State B by Subsidiary B, State A will impose its tax on $4,000 and State B on $6,000.

In other words, the unitary system is a relational concept while the separate entity arm's length method is a source concept. Seldom, if ever, will the two methods produce a similar result when applied to businesses conducted in foreign countries having quite different economic and social environments. The divergence of the two methods is significant when substantial differences in the profit rates among taxing jurisdictions are created by differences in the cost of capital goods, labor productivity, market forces and management efficiencies. The first three of these have a direct, but inverse, impact on the factors of the apportionment formula in relation to profit rates and the fourth is not reflected in the factors at all. As more fully developed hereinafter, higher factor costs in the United States and relatively lower profit margins as compared to those in foreign countries benefit states using the unitary system worldwide and greatly enhance the risk of multiple taxation of income earned by corporations abroad.

The underpinning of this combined reporting procedure is the "unitary" relationship that must exist between members of the group. The "unitary" doctrine had its origin in property and capital stock taxes applied by the states to railroad and telegraph companies. State income tax cases followed the principles of these earlier property and capital stock cases and defined a "unitary business" as one having a substantial transfer of products between intrastate and extrastate operations. This basic definition has continued to be predominant in cases involving manufacturing, producing and mercantile companies. *E.g.*,

Exxon Corp. v. *Wisconsin Department of Revenue*, 447 U.S. 207 (1980) (integrated petroleum business); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (integrated petroleum business); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978) (integrated manufacture and sale of animal feeds); *Butler Bros.* v. *McColgan*, 315 U.S. 501 (1942) (integrated wholesale business); *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271 (1924) (integrated manufacture and sale of ale); *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters).

The Court has historically sanctioned the use of the formula apportionment method to determine the income tax liability of a corporation doing business both inside and outside the state only if and to the extent that the income being apportioned is derived from a "unitary business" in which the activities being conducted outside the taxing state are functionally integrated with the activities being conducted inside the state. In all cases, functional integration has been evidenced by a substantial transfer of products.

In *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the Court enunciated the general principle underlying a state's apportionment and taxation of extraterritorial income, stating that "the linchpin of apportionability is the unitary business principle". 445 U.S. at 439. To avoid apportionment of dividend income, this Court explained that a taxpayer must show that the payor's income is earned in the course of activities unrelated to the business within the taxing State. In other words, to avoid apportionment, the taxpayer can show that the foreign operations of its subsidiaries and affiliates are distinct in a business or economic sense from its activities in a taxing state. There, Mobil failed to offer any evidence that its foreign subsidiaries were engaged in business activities unrelated to its "integrated petroleum business", 445 U.S. at 428, a part of which was conducted in the taxing state.

The "unitary business" principles of *Mobil* were reiterated shortly thereafter in *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980):

> "In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of the activities unrelated to the sale of petroleum products in that State.' . . . The court looks to the 'underlying economic realities of a unitary business,' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise,' 445 U.S., at 441, 442, 439." 447 U.S. at 223-224.

Upon examination of Exxon's organizational structure and business operations, the Court found that Exxon was "a highly integrated business which benefits from an umbrella of centralized management and controlled interaction". 447 U.S. at 224.

Most recently, in *ASARCO, Inc.* v. *Idaho State Tax Commission*, 50 U.S.L.W. 4962 (June 29, 1982), and *F. W. Woolworth Co.* v. *Taxation and Revenue Department of New Mexico*, 50 U.S.L.W. 4957 (June 29, 1982), the Court rejected the states' apportionment and taxation of dividends received by the nondomiciliary parent corporations from their non-United States subsidiaries after finding that, unlike Mobil and Exxon, each of the taxpayers had succeeded in proving that the dividend-paying subsidiaries were not part of its unitary business but rather were "discrete business enterprises", 50 U.S.L.W. at 4961, which in "any business or economic sense" had "nothing to do with the activities" of the parent corporation in the taxing state. 50 U.S.L.W. at 4968.

The Court, in *Woolworth*, spelled out the limitations of the "unitary business" principles stated in *Mobil*. The question relevant to a state's right to tax dividends from foreign subsidiaries is "whether 'contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale.' 445 U.S., at 438. If

such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State. *Ibid.*" *Woolworth*, 50 U.S.L.W. at 4959.

Upon finding that the essential factors did not exist to evidence an underlying "unitary business" between Woolworth and its foreign subsidiaries, the Court stated that "[t]here is a critical distinction between a retail merchandising business as conducted by Woolworth and the type of multinational business—now so familiar—in which refined, processed, or manufactured products [or parts thereof] may be produced in one or more countries and marketed in various countries, often worldwide. In operations of this character there is a flow of international trade, often an interchange of personnel, and substantial mutual interdependence. The uncontradicted evidence demonstrates that Woolworth's international retail business is not comparable. There is no flow of international business. Nor is there any integration or unitary operation in the sense in which our cases consistently have used these terms." 50 U.S.L.W. at 4961.

That the absence of a flow of international business, a substantial transfer of common products, between the affiliated corporations was also critical in the *ASARCO* case can be discerned in the Court's footnoted response regarding the foundation of the "unitary business" principle, wherein it was stated:

> "As we recognize in the Court's opinion, these cases are decided on their facts in light of established general principles. The most comprehensive discussion of the factors that are relevant is contained in our recent decisions in *Mobil* and *Exxon*. In both of those cases, that we follow today, the *states prevailed because it was clear that the corporations operated unitary businesses with a continuous flow and interchange of common products*. ASARCO has proved that these essential factors are whol-

> ly absent in this case. It is late in the day to confuse this important area of state tax law by rewriting the standards of *Mobil* and *Exxon*." (emphasis added) 50 U.S.L.W. at 4968, n. 24.

The Court has made it clear that, consistent with due process requirements, a substantial transfer of products or flow of goods between the taxpayer corporation and its subsidiaries and affiliates is integral to a finding that the corporate members of a combined group are engaged in a "unitary business". The absence of an ongoing interchange of common materials and products, as lacking in *ASARCO* and *Woolworth*, would compel the conclusion that a "unitary business" does not exist.

Here, the record shows that Appellant, Container Corporation of America (Container), and its foreign subsidiaries carried on their businesses separately and independently. The operations of the foreign subsidiaries were highly decentralized so that the subsidiaries located in each particular country operated as autonomous businesses, rarely crossing national borders. There was no significant flow of goods or transfer of products comparable to that in *Mobil* and *Exxon*. The involvement of Container management in decisions affecting the foreign subsidiaries was limited to decisions about appropriations involving major capital expenditures. Container provided its subsidiaries with little material assistance in developing technology and charged its foreign subsidiaries for all information provided. The foreign subsidiaries generally obtained financing from local sources. There were no substantial centralized services performed by Container for the subsidiaries or by the subsidiaries for each other or Container. In short, there was no functional integration, centralization of management or achievement of other economies of scale that would support the application of "combination" apportionment to Container and its foreign subsidiaries.

California relied upon Container's ownership of more than 50 percent of the voting stock of its foreign subsidiaries; the fact that the foreign subsidiaries were engaged in the same type of business as Container; and upon minor contacts and oversight responsibilities with respect to the subsidiaries, which, in the aggregate, were substantially less significant than the relationships between Woolworth and its subsidiaries, to support a "unitary business" finding for the purpose of applying its "worldwide combined" formula method to Container and its foreign subsidiaries. No attempt was made by California to explain how these activities of this Chicago-headquartered corporation caused it to allegedly understate its California taxable income. On the contrary, and as hereinafter set out, Container has amply demonstrated that the application of the "worldwide combined" formula method to it and its foreign subsidiaries operating in dissimilar economic and social environments has substantially overstated its California taxable income.

While *ASARCO* and *Woolworth* dealt with the taxation of a portion of intangible income received by a nondomiciliary parent corporation from subsidiary corporations having no other connection with the taxing state, the issue in this case is the constitutionality of including in the tax base of a nondomiciliary parent corporation the income of subsidiary corporations conducting discrete businesses in foreign countries and having no connection with the taxing state. In an economic or business sense, there is no basis for a state to combine the income and apportionment factors of subsidiary corporations doing business in foreign countries with the income and factors of the parent corporation doing business in the state in order to determine the parent corporation's taxable income when the subsidiary corporations are discrete businesses operating as autonomous entities.

California has applied its "worldwide combination" method in order to determine Container's taxable income despite the fact that the income of its foreign subsidiaries is unrelated to Container's business activities in California. The record herein shows that there was clearly no "unitary business" relationship between Container and its foreign subsidiaries. California's resort to this method is simply an effort to reach profits earned elsewhere. For this reason alone, California's attempt to impose "worldwide combination" herein should be rejected.

Application Of Worldwide Formula Apportionment Results In Such Gross Distortion As To Violate Due Process

Where a state seeks to impose a tax on income generated by interstate and intrastate activities, the Due Process Clause of the Fourteenth Amendment requires that there be at least a " 'minimal connection' between the interstate activities and the taxing state, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise". *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 437. If an apportionment formula results in the taxation of income out of all reasonable proportion to the corporation's business activities within the state, the formula violates the Due Process Clause. *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123 (1931); *McDonnell Douglas Corp.* v. *Franchise Tax Board*, 69 Cal. 2d 506, 446 P.2d 313 (1968).

Formula apportionment has long been accepted as reasonable when applied to a single multistate corporation within the homogenous states of the United States. *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942). However, it creates distortion and multiple taxation when applied to the "worldwide combined" income of multinational corporations. On July 10, 1981, John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, stated succinctly:

> "In terms of economic rationale, formula apportionment [in a "worldwide combined" context] has little merit because a corporation could have an increased tax burden

> merely as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a Taxpayer's income."[1]

Formula apportionment does not provide a fair measure when it is applied on a "worldwide combined" basis. In theory, this combined report is not a tax return but merely a device to arrive at a taxpayer's income derived from sources within the state. Also in theory, the combined report is not intended to tax one corporation's income as if it were the income of another corporation. In practice, however, the opposite result occurs. Income of the affiliated corporations is recast as the income of the jurisdictionally present corporation and then apportioned to the state without taking into account the essential elements responsible for the earning of the affiliates' income.

The experience of COST members shows that foreign wages are generally lower than U.S. wages and profits of foreign subsidiaries are generally higher. In many instances, foreign properties, such as oil wells in OPEC countries, are much more productive than U.S. properties and, therefore, substantially less foreign property may be required to produce the same amount of foreign income as produced domestically. Thus, the application of formula apportionment to "worldwide combined" income attributes a disproportionnate amount of income to the state applying formula apportionment to "worldwide combined" income.

Income taxes in many foreign countries are levied at much higher rates than in the United States. Since a "worldwide combined" state, which does not permit foreign income taxes to be deducted, has state taxable income (and consequently, the tax) which increases as foreign taxes increase, even though the

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[1] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 93 (September 30, 1981).

combined corporation's actual profit remains the same, a gross distortion in the amount of income attributed to the taxing state results. Accordingly, when an apportionment formula is applied on a "worldwide combination" basis, there is no rational relationship between the income attributed to the state and the intrastate values of the business enterprise.

The difficulties inherent in fairly apportioning income among the various states in which a business is conducted have long been recognized. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 120-121 (1920). If a taxpayer shows that "the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result", *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. at 121, or that the income attributed to the state was "out of all appropriate proportion to the business transacted . . . in that state", *Hans Rees' Sons* v. *North Carolina ex rel. Maxwell*, 283 U.S. at 135, or that the formula "led to a grossly distorted result", *Norfolk & Western Railway Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 326 (1968), then Due Process is violated. For all of these reasons, the "worldwide combined" method imposed by the California Franchise Tax Board violates Due Process in this case and in most cases of our other members.

The "worldwide combination" apportionment method thus creates a blatant violation of Due Process. Distortion in the apportionment factors not only results in extraterritorial income being apportioned to the states but also causes apportionment of a disproportionate amount of foreign income due to the disparity in property and payroll values. Consistent with constitutional principles and judicial precedents, this method should not be allowed.

Commerce Clause

Formula apportionment of "worldwide combined" income of affiliated corporations for state income tax purposes (a) creates

a substantial risk of international multiple taxation and (b) prevents the United States government from speaking with one voice in regulating commercial relations with foreign governments.

Japan Line, Ltd. v. *County of Los Angeles*, 441 U.S. 434 (1979), sets forth the governing principles under the Commerce Clause. There, the Court reiterated the standard applicable to a tax on interstate commerce set out in *Complete Auto Transit Inc.* v. *Brady*, 430 U.S. 274, 279 (1977): "If the state tax 'is applied to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State,' no impermissible burden on interstate commerce will be found." 441 U.S. at 444-445.

With respect to state taxation which impacts foreign commerce, the Court explained in *Japan Line* that two additional standards must be met (441 U.S. at 446, 448):

> "When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations beyond those articulated in *Complete Auto*, come into play. The first is the enhanced risk of multiple taxation.
>
> * * *
>
> "Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential."

The Court then ruled that:

> "In addition to answering the nexus, apportionment and nondiscrimination questions . . ., a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'. If a state tax contravenes either of these precepts,

it is unconstitutional under the Commerce Clause." 441 U.S. at 451.

The rationale of *Japan Line* is fully applicable in the instant case. The constitutional limitations which apply to state taxing powers do not differentiate between different kinds of taxes. Taxes which result in multiple burdens on interstate or foreign commerce are invalid regardless of the kind of tax involved. *See, e.g., Evco* v. *Jones*, 409 U.S. 91 (1972); *Standard Oil Company* v. *Peck*, 342 U.S. 382 (1952). The gravamen of an invalid tax is its burden on commerce and not what it is called or to what asset it is applied.

Worldwide Combined Apportionment Inherently Creates International Multiple Taxation

Formula apportionment of "worldwide combined" income of affiliated corporations inherently creates a substantial risk of international multiple taxation. As stated by then Assistant Secretary of the Treasury, Laurence N. Woodworth:

> "Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation."[2]

Dr. Woodworth further noted:

> "[L]abor costs vary substantively among countries — very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong

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[2] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 34 (1977).

> Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California."[3]

Application of the apportionment formula method on a "worldwide combination" basis creates more than the inherent risk of multiple taxation. It *does* produce multiple taxation. Income of a foreign subsidiary is taxed by one or more foreign countries which employ the federally-accepted and internationally-accepted arm's length concept set forth in Federal Treasury Regulation section 1.482-1(b). By applying a state apportionment method on a "worldwide combination" basis, income which has already been fully taxed on an unapportioned basis in the foreign countries under the arm's length concept is attributed to the state under the apportionment formula. Thus, multiple taxation results because "neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign". *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. at 447.

In the case at hand, the prohibited international multiple taxation is generated by California's "worldwide combination" formula as set forth on pages 9, 10 and 11 of the Jurisdictional Statement filed with the Court on September 14, 1981 by the Appellant:

> "Double taxation results because the income of the foreign subsidiaries is taxed in their respective countries on an arm's-length basis, *i.e.*, the income earned by a particular subsidiary was taxed in its country of operation without reference to income of its domestic parent. Stip. ¶¶ 139-140. By contrast, California taxed the apportioned segment of the world-wide income, taking into account the same income (before foreign tax) of the foreign subsidiaries which have already been taxed in those foreign

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[3] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations,* 95th Cong., 1st Sess. 34 (1977).

countries. This results in a double tax burden on income from foreign commerce to which domestic commerce is not exposed.

"Double taxation can be illustrated by application of California's own apportionment formula. That is to say, if one applies the three-factor formula with the numerator being domestic payroll, property and sales and the denominator being world-wide payroll, property and sales, and if the percentage produced by averaging those three fractions is multiplied by world-wide income, the result is the following increase in domestic Container income over that reported to the Internal Revenue Service for domestic Container operations:

1963	1964	1965
$2,407,000	$3,966,000	$5,466,000

"This double taxation is confirmed by a comparison of the income attributed to the various countries under an arm's-length analysis with that assigned to the countries by the use of California's apportionment formula. [4]

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[4] This method of using the California formula to determine the income attributable to the parent and subsidiary was approved by the California Supreme Court in *Safeway Stores, Inc.* v. *Franchise Tax Board*, 3 Cal. 3d 745, 754, 91 Cal. Rptr. 616, 621 (1970).

	Average Pre-Tax Income Per Arm's-Length in Different Countries 1963/64/65	Average Pre-Tax Income per World-Wide Apportionment 1963/64/65
CCA (United States)...	$28,121	$32,068
Columbia.....	4,254	2,203
Mexico	1,605	1,430
Venezuela	4,246	1,907
Panama	1,286	—
Austria.....	(13)	11
Germany	1,793	2,906
Holland	384	197
Italy.....	34	968
Total Foreign	13,588	9,642
Total Combined	$41,710	$41,710

000's omitted — Sch. VI to Exh. 1, Stip. re Testimony, C.T. 289.

"Multiple taxation is illustrated from the fact that the apportionment formula attributes to other countries approximately one-half of the income produced in Columbia and Venezuela according to arms's-length principles applied to those countries. In Columbia's case, for example, this produces the ludicrous result of apportioning about the same pretax *income* to Columbia as the Colombian subsidiaries paid in Colombian income *taxes*. The *income* attributed to Colombia by the California formula for the years in question [illegible], respectively, $1,960,000, $2,454,000, $2,195,000. For the same years, the actual Colombian tax liability was determined to be $2,508,036,

$2,533,755, and $1,484,104, respectively.[5] This is a severe dislocation of the tax base."

This international multiple taxation problem is further compounded when a "worldwide combination" state takes a fifty-one percent (or more) affiliate and includes one hundred percent of its income in the tax base.

One Voice Should Regulate Foreign Commerce

Many U.S. parent corporations conduct business only in the United States and have subsidiaries which do business abroad. Many foreign-parent corporations conduct no business in the United States and have subsidiaries which do business here.[6] In both cases, each of the related corporations (*i.e.*, domestic and foreign subsidiaries, parent corporation, brother-sister corporations) is treated as an independent entity operating on an arm's length basis for income tax purposes by the United States, by foreign countries and by most states.

The single entity arm's length concept was adopted in the first income tax convention to which the United States was a party, Income Tax Convention, April 27, 1932, United States-France, art. IV, 49 Stat. 3145, T.S. No. 885, and it has been the

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[5] Second Addendum to Stip. ¶ 159, C.T. 147-149. As a further example by application of its formula California has alleged that on average for the years in issue only $197,000 of income can be attributed to the Dutch subsidiary. In fact, the Dutch subsidiary paid Dutch taxes on the basis of $384,000 per year. The actual taxes paid to the Dutch government averaged 97 percent of the income attributed to Holland by the California formula. *Id.*

[6] Discriminatory treatment in favor of foreign-parent corporations with U.S. subsidiaries vis-a-vis U.S. parent corporations with foreign subsidiaries would, of course, be improper. *See Zee Toys, Inc.* v. *County of Los Angeles*, 85 Cal. App. 3d 763 (Ct. App. 1978), *aff'd by an equally divided court sub nom. Sears, Roebuck & Company of Los Angeles*, 449 U.S. 1119 (1981).

basis of *all* of our subsequent tax treaties. This approach is considered the "internationally accepted norm"[7] and it is incorporated in the model convention proposed by the Organization for Economic Cooperation and Development (OECD), of which the United States is a member.[8] This concept is also reflected in Articles 7 and 9 of the United States Model Income Tax Treaty, which the Department of Treasury announced on May 18, 1976 (41 Fed. Reg. 20427) and again most recently on July 20, 1981 (46 Fed. Reg. 37432).

The California Franchise Tax Board has substituted formula apportionment in a multicorporate context for the internationally-accepted arm's length concept. The Franchise Tax Board has made the substitution by extending the application of its three-factor apportionment formula (used for dividing the income of a single multistate corporation) to the "worldwide combined" income of a taxpayer and its affiliates operating abroad.

John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, reported on July 10, 1981 that formula apportionment is not widely used by the states in a multicorporate context. He stated that "it is, with very few exceptions, used by the states only to divide the income of a single multistate corporation, which is a totally different matter".[9] Mr. Chapo-

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[7] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[8] *State Taxation of Foreign Source Income: Hearings on H.R. 5076 before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 301 (1980) (Statement of John S. Nolan, on behalf of the Confederation of British Industry).

[9] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 93 (September 30, 1981).

ton also noted that "some of the few states who use it, such as California, are considering abandoning it". [10]

Actually, formula apportionment of "worldwide combined" income in a multicorporate context is being aggressively pursued by Alaska, California, Colorado, Idaho, Montana and Oregon, all of which are members of the Multistate Tax Compact. *U.S. Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452, 454 n.1 (1977). Illinois Department of Revenue seeks to join this group through its "friendly" lawsuit currently before the Court. *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co., Illinois Department of Revenue, et al.*, No. 81-349 (argued April 19, 1982, restored to calendar on May 3, 1982 for rehearing next term). However, the Illinois Legislature has recently passed a measure which would prohibit "worldwide combination" for 1982 and subsequent years. [11]

The U.S. Treasury Department has received numerous requests from other nations seeking protection from state formula apportionment of "worldwide combined" income in a multicorporate context. [12] The state practice of formula apportion-

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[10] Comp. Gen. Rep. to Chairman, House Comm. on Ways and Means, app. IX at 94 (September 30, 1981).

Assembly Bill 525, which passed the California Assembly in February, 1980 by a vote of 64-10, precluded the California Franchise Tax Board from requiring use of combined reporting by foreign corporations with United States subsidiaries doing business in California. The California Senate approved an amended version of AB 525. The Senate and House could not agree on the final version of the bill.

[11] House Bill 2588, which eliminates combined reporting on both a domestic and worldwide basis, passed the Illinois House on a vote of 108-46 and the Senate on a vote of 46-12. This bill is currently awaiting the Governor's action.

[12] *See* Report of the Department of State to the President (June 8, 1976): "This method of assessment, which includes the burden of producing worldwide records of all of the affiliated companies, has raised many objections

ment of "worldwide combined" income "has created, and continues to create, an irritant in the international relations of the United States". [13] This irritation has created a potential for retaliation through discriminatory taxes by foreign governments against U.S. citizens or corporations. On April 27, 1982 in a debate in the British House of Commons between the Financial Secretary to the Treasury, Nicholas Ridley, and Chairman of the Conservative Party's Industry Committee, Michael Grylls, a warning was issued that substantial pressure is being exerted in the British Parliament to take retaliatory legislative action to apply a "worldwide combined" reporting system on U.S. corporations which operate in Britain. [14] As the Court stated in *Japan Line:*

> "If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer." 441 U.S. at 450.

In testimony before the U.S. Senate Foreign Relations Committee on July 19, 1977, Assistant Secretary of the Treasury, Laurence N. Woodworth, stated that state formula apportionment in an international context produces complaints from our

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by our treaty partners and we are now seeking to deal specifically with this problem in our treaties." CCH Tax Treaties ¶ 8103 EE.

[13] *State Taxation of Foreign Source Income: Hearings on H.R. 5076 before the House Comm. on Ways and Means*, 96th Cong., 2d Sess. 7 (1980) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

[14] Hansard, British Firms Overseas (Taxation) at 823-828 (April 27, 1982).

treaty partners and varies from the internationally-accepted arm's length practice, leading to possible double taxation and, in effect, extraterritorial taxation. [15]

Application of the apportionment formula method on a "worldwide combination" basis is thus a clear violation of the second test of *Japan Line*. It impairs "federal uniformity in an area where federal uniformity is essential". 441 U.S. at 448. The major trading nations of the world and the tax treaties between the United States and other countries apply the separate corporate entity approach pursuant to the internationally-accepted arm's length standard. At the federal level, the United States has spoken uniformly in this crucial area of taxes on international trade and foreign commerce where federal uniformity is so essential. That voice is reflected in our many tax treaties, in the use of the arm's length concept under Internal Revenue Code section 482 rather than formula apportionment for federal income tax purposes, in the enactment by Congress in 1959 of Public Law No. 86-272 (73 Stat. 555) limiting the jurisdictional bases open to states for taxation and in the numerous pronouncements by high executive officials in the government. [16]

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[15] *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 33 (1977).

[16] *In U.S. Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. at 488-499 (1977), Mr. Justice White, in his dissent with which Mr. Justice Blackmun concurred, stated that "both Congress and the Executive have clearly demonstrated that there is a federal interest in the rules for apportioning multistate and multinational income. The Executive cannot constitutionally express his federal sovereign interest in the matter any more unambiguously. He has negotiated a treaty with a foreign power and submitted that treaty to the Senate. As for the Congress, its federal sovereign interest in the topic was early established in Public Law No. 86-272".

The California Franchise Tax Board endeavors to contradict the voice of the United States with respect to the arm's length method by seeking the approval of this Court of its inconsistent "worldwide combination" formula. Its "worldwide combination" method directly burdens foreign commerce in contravention of this Court's decision in *Japan Line*.

Appellee will argue that "worldwide combination" does not burden the Commerce Clause because the California Franchise Tax Board is not directly taxing the income of a foreign corporation. What is overlooked, however, is that the state is recasting the income of foreign corporations (including income which has satisfied the I.R.C. section 482 arm's length test) and taxing it as if it were the income of the jurisdictionally-present taxpayer. By this guise, the state is doing indirectly (*i.e.* taxing foreign income in a "worldwide combined" report) what it is prohibited from doing directly (*i.e.* taxing the foreign corporation). This should not be allowed. It would substitute multiple voices (the states) for the one voice of the United States government despite both the practical necessity and constitutional requirement for "speaking with one voice" in the area of foreign commerce.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below and remand the case to the Court of Appeal of California, First Appellate District, for further proceedings in conformity with this Court's opinion.

Respectfully submitted,

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